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# On Contractual Defaults and Experimental Law and Economics

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## On Contractual Defaults and Experimental Law and Economics

*Comment*

by

AVISHALOM TOR\*

Experimental methodologies generally and experimental economics specifically have the advantage of providing controlled tests of hypotheses regarding the relationship among variables of legal relevance (CAMERER AND TALLEY [2005], TOR [2007]). In fact, experimental law and economics (“ELE”) – which uses the methodology of experimental economics – has already made significant contributions to legal scholarship. The application of any methodology without awareness of its inherent limitations, however, may well diminish its validity, and ELE is no exception. This comment on SLOOF, OOSTERBEEK, AND SONNEMANS’ [2007] (“SOS”) interesting and clear experiment<sup>1</sup> will emphasize both ELE’s potential and its limitations.

SOS examined the impact of contractual defaults in a bilateral game, with full information and monetary incentives for performance. Participants were paired, one (“Proposer”) proposing a contract of his choice – either the default or one of three other contracts – and the other (“Respondent”) deciding whether to accept the proposal. When the default contract was proposed, as well as whenever Respondent rejected the proposal, the default contract applied. SOS found participants neither more likely to propose nor more likely to accept the default contract, compared to the alternative contracts. They therefore concluded that *default remedies had little to no effect on participants’ choice of contract* (“the No Bias Finding”).

The No Bias Finding fits the rational choice prediction that contract default rules will not be “sticky.” Such rules should have no effect on the choices of contracting parties – who will rely on efficient defaults and contract around inefficient ones – in the absence of transaction costs, externalities, or information asymmetries.<sup>2</sup> After

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<sup>1</sup> Given space constraints, this comment discusses only some of the intriguing SOS results.

<sup>2</sup> A typical recent statement of this traditional law and economics view is POSNER [2003, p. 98].

controlling for the latter variables, SOS were not expected to observe default contract stickiness. At the same time, however, the No Bias Finding seems to contradict an extensive body of empirical evidence suggesting that default rules may well be sticky beyond the predictions of rational choice models.

In one of only two earlier specific experimental tests of contractual defaults, KOROBKIN [1998] used three contract negotiation scenarios. Participants were told they represented a company and responded to measures of their preference for the particular contract term at stake. The results showed a consistent bias in favor of the *status quo* default term; labeling a given term the default significantly strengthened participants' preference for that term. These results are in accord with an extensive experimental literature on the impact of defaults, the *status quo*, and reference points more generally on preferences (e.g., KAHNEMAN, KNETSCH, AND THALER [1990]; KAHNEMAN AND TVERSKY [1979]; SAMUELSON AND ZECKHAUSER [1988]; but see PLOTT AND ZEILER [2005]),<sup>3</sup> which is further corroborated by a diverse body of field evidence (CAMERER [2000]).<sup>4</sup>

It is possible that contract default rules, whose relevance is *contingent* upon parties' agreement to contract, differ from other default states. Parties therefore might not perceive contingent contractual defaults as relevant reference points (KOROBKIN [1998]; SCHWAB [1988]). Ironically, however, the SOS "default contract" applied *inevitably* whenever proposed and whenever Respondents rejected a non-default proposal, bearing greater resemblance to a legal right than to a contractual default. Thus, the contingency of typical contractual defaults cannot account for the No Bias Finding.

Other aspects of the SOS experimental design, on the other hand, may explain the No Bias Finding. Specifically, the SOS participants chose among *monetary gambles under risk* (with no uncertainty), with the defaults comprising explicit risky gambles as well and providing *no fixed reference points*. Participants also faced only expected total *gains*. And, finally, the gambles were color-coded "contracts," *devoid of the very institutional and legal context* that define a real-world contract, remedy, or default rule.

These characteristics largely reflect a laudable adherence to experimental economics conventions, including the provision of monetary incentives for performance; the measurement of behavior rather than verbal responses; and the abstract description of experimental settings (CAMERER AND TALLEY [2005]). The same design characteristics, however, also generated a context in which the very phe-

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<sup>3</sup> Additional related phenomena include omission bias, regret and decision avoidance, inertia and more.

<sup>4</sup> There is also specific anecdotal evidence of parties' reluctance to contract around *legal* defaults that appears largely inexplicable from a rational choice perspective. DONOHUE [1991] noted that litigants do not contract around the legal rule concerning the allocation of litigation costs, even where beneficial. FARNSWORTH [1999] examined a random set of 20 nuisance cases after judgment, finding no bargaining; the parties' lawyers also did not believe there would have been bargaining if the results were reversed.

nomenon SOS sought to test was unlikely to manifest itself: Neither endowment nor loss aversion typically occur for money (KAHNEMAN, KNETSCH, AND THALER [1990]); loss aversion also requires uncertainty about the benefits of the tradeoff between alternative states (NOVEMSKY AND KAHNEMAN [2005]);<sup>5</sup> those reference points that generate loss aversion or a *status quo* bias, moreover, are typically certain (or at least appear so to decision makers) rather than comprising explicit monetary gambles; and, finally, loss aversion would be unlikely to appear in choices among potential gains.

An adoption of the default contract as a reference point – and the resulting perception of a potential loss on the part of participants – still might have been achieved in a richer, more realistic, institutional or legal context, resembling that of KOROBKIN [1998], but such a context was intentionally avoided. Given the totality of the SOS experimental design, therefore, results showing the default contract to impact participants' choices would have been dramatic indeed. The present No Bias Finding, on the other hand, accords with the findings of the broader behavioral literature and the rational choice prediction alike.

The methodological conventions of experimental economics can contribute to legal analysis. When studying repetitive behavior in markets, for instance, the use of multiple trials and the provision of monetary performance incentives will often be appropriate.<sup>6</sup> When studying legal behavior, however, one must take care not to abstract from those aspects of the legal context that shape and define this behavior in the real world (see RACHLINSKI [2000]). Such a careful approach would not limit ELE, but rather make it a more valid, versatile, and effective tool for legal analysis.

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<sup>5</sup> The elimination of uncertainty about the outcomes of contractual alternatives was probably responsible for the limited effect of defaults in SCHWAB'S [1988] early experiment as well (KOROBKIN [1998]).

<sup>6</sup> Although the power of those monetary incentives typically used in experiments is limited. Such incentives, moreover, generally do not lead to very different results from those of studies not using monetary performance incentives (CAMERER AND HOGARTH [1999]).

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